

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**



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Application of California-American Water Company (U 210 W) to Decrease Revenues for Water Service in its Coronado District by (\$73,100) or (0.46%) in 2008 and Increase Revenues by \$266,200 or 1.67% in 2009 and \$260,900 or 1.61% in 2010	A.07-01-036 (Filed January 22, 2007)
Application of California-American Water Company (U 210 W) to Increase Revenues for Water Service in its Larkfield District by \$1,272,000 or 61.91% in 2008, \$134,300 or 3.94% in 2009 and \$129,900 or 3.67% in 2010 Under the Current Rate Design or Decrease Revenues by (\$742,200) or (36.12%) in 2008 and Increase Revenues by \$50,000 or 3.72% in 2009 and \$63,500 or 4.55% in 2010 Under the Proposed Rate Design	A.07-01-037 (Filed January 22, 2007)
Application of California-American Water Company (U 210 W) to Increase Revenues for Water Service in its Sacramento District by \$8,966,900 or 33.89% in 2008, \$1,905,700 or 5.36% in 2009, and \$1,860,700 or 4.97% in 2010 Under the Current Rate Design or by \$10,981,000 or 41.50% in 2008, \$1,925,900 or 5.11% in 2009, and \$1,845,600 or 4.66% in 2010 Under the Proposed Rate Design	A.07-01-038 (Filed January 22, 2007)
Application of California-American Water Company (U 210 W) to Increase Revenues for Water Service in its Village District by \$1,537,300 or 7.43% in 2008, \$243,400 or 1.08% in 2009, and \$232,900 or 1.02% in 2010	A.07-01-039 (Filed January 22, 2007)

**COMMENTS OF CALIFORNIA-AMERICAN WATER COMPANY ON THE
PROPOSED DECISION ON THE REVENUE REQUIREMENTS FOR THE VILLAGE
AND CORONADO DISTRICTS**

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March 3, 2008

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**

Application of California-American Water Company (U 210 W) to Decrease Revenues for Water Service in its Coronado District by (\$73,100) or (0.46%) in 2008 and Increase Revenues by \$266,200 or 1.67% in 2009 and \$260,900 or 1.61% in 2010	A.07-01-036 (Filed January 22, 2007)
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I. INTRODUCTION

Pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure, California-American Water Company ("California American Water") hereby submits its opening comments on the Proposed Decision of Administrative Law Judge Rochester on the Revenue Requirements for the Village and Coronado Districts, mailed on February 11, 2008 ("Proposed Decision"). California American Water generally supports the Proposed Decision, in particular its adoption of the settlement between the Division of Ratepayer Advocates (DRA) and California American Water. California American Water takes issue, however, with the Proposed

Decision's flawed Return on Equity (ROE) analysis and the rejection of a financial risk component for California American Water. California American Water urges the Commission to modify the Proposed Decision's conclusions on ROE as discussed below.¹ California American Water also addresses the Proposed Decision's recommendation on the implementation of the Infrastructure System Replacement Surcharge (ISRS) program for California American Water's Coronado and Village Districts, but does not suggest any changes to the Proposed Decision on this issue.

II. THE PROPOSED DECISION'S RETURN ON EQUITY ANALYSIS CONTAINS LEGAL AND FACTUAL ERRORS

As California American Water discussed at length in its Opening Brief and Reply Brief, California American Water's recommended 11.5 percent ROE is supported by the facts, widely accepted financial policy and theory and Commission precedent. As set forth in the Briefs, the Commission must adopt an ROE that both recognizes California American Water's financial risk and levels the playing field with regard to other Commission-regulated water companies.² In the interest of efficiency, California American Water will not repeat the arguments made in its Opening and Reply Briefs regarding California American Water's recommended ROE and why it is just and reasonable. Rather, these comments address only the legal and factual errors relating to the Proposed Decision's adoption of a 10.15 percent ROE.

First, the Proposed Decision adopts an ROE of 10.15 percent, asserting that the 10.15 percent ROE "is comparable to the returns on investments of like companies."³ This statement is incorrect. Importantly, the record shows that the Proposed Decision's recommended

¹ Pursuant to Rule 14.3(b), California American Water's revised findings of fact and conclusion of law are attached as Exhibit A.

² California American Water's Opening Brief, pp. 6-7, 9; California American Water's Reply Brief, pp. 4-6.

³ Proposed Decision, p. 21 (emphasis added).

ROE of 10.15 percent is lower than the return the Commission has recently authorized for other investor-owned water utilities and does not include any financial risk component.⁴ Both California American Water and DRA agreed that California American Water's financial risk is higher than other water utilities.⁵ Increased debt increases financial risk, which requires a higher return on equity to attract investment.⁶ Therefore, investors require a higher return for investing in a water utility, such as California American Water, that has more debt.⁷ Despite this evidence, however, and without any supporting evidence, the Proposed Decision claims that California American Water's return on investment is comparable to other water utilities. Factually, California American Water's return is not comparable because the Proposed Decision's ROE analysis fails to include a financial risk component to address California American Water's higher level of debt. In order to create a comparable return on equity for California American Water, the Commission must adjust its estimate of the cost of equity to reflect California American Water's increased financial risk.

Second, the Proposed Decision's conclusion that the Commission should reject California American Water's proposed financial risk component is invalid. The Proposed Decision concludes that California American Water's leverage ratio does not warrant use of a financial risk component because the "debt to equity ratio, although higher than the comparable

⁴ See e.g., D.07-06-024, *In the Matter of the Application of Valencia Water Company (U-342-W), a Corporation, for an Order Authorizing It to Increase Rates Charged for Water Service in Order to Realize Increased Annual Revenues of \$ 3,470,000 in a Test Year Beginning July 2007, \$ 864,000 in a Test Year Beginning July 2008, and to Make Further Changes and Additions to Its Tariff for Water Service*, 2007 Cal. PUC LEXIS 273 (authorizing ROE of 10.19 percent); D.05-12-020, *In the Matter of the Application of Apple Valley Ranchos Water Company (U346W) for Authority to Increase Rates Charged for Water Service by \$ 2,748,100 or 18.56% in 2006, \$ 496,580 or 2.69% in 2007, and \$ 1,075,879 or 5.46% in 2008*, 2005 Cal. PUC LEXIS 533 (authorizing ROE of 10.15 percent).

⁵ Proposed Decision, p. 21.

⁶ Exhs. 4, 8, 10, 12, Reiker Direct, p. 31; RT 288:2-12 (Willis/DRA).

⁷ *Id.*

water companies, does not adversely affect the S&P credit rating of its parent company.”⁸ As an initial matter, the Proposed Decision’s conclusion is contradicted by basic finance principles that investors require a higher return for investing in a water utility that has more debt.⁹ Equally troubling, however, is the Proposed Decision’s assumption that California American Water’s parent company, American Water, will continue to invest in California American Water at a loss indefinitely. The credit rating of American Water’s subsidiaries cannot be sustained if each of the subsidiaries is regulated as if there is no need to provide a rate of return on equity consistent with that rating.

Third, the Proposed Decision acknowledges the fact that California American Water performed a capital asset pricing model (“CAPM”) analysis, as well as the VS growth in its discounted cash flow (DCF) forecast.¹⁰ The Proposed Decision, however, fails to explain why the analysis in its ROE calculation does not reflect the CAPM cost of equity. Similarly, the Proposed Decision fails to explain why it arbitrarily omits the VS growth. Although California American Water’s requested 11.5 percent return on equity would be justified even if the Commission rejected the use of VS growth, VS growth is justified because the average market-to-book ratio of sample companies indicates that they are not expected to issue future shares at prices equal to book value.¹¹ The Proposed Decision erred by not addressing these issues.

Fourth, the Proposed Decision relies upon data from a prior decision to reach the incorrect conclusion that California American Water regularly overearns. The Proposed Decision refers to D.06-11-050, which discussed California American Water’s history of

⁸ Proposed Decision, p. 21.

⁹ Opening Brief, pp. 5-6.

¹⁰ The VS growth is the company’s dividend growth through the sale of stock and is required when the company is not expected to issue new shares at prices equal to book value. *See* Proposed Decision, p. 16 (recognizing that the CAPM analysis yields an average 12.4% CAPM cost of equity), pp. 17-18 (discussing the VS growth rate).

¹¹ Reply Brief, pp. 10-11.

overearning.¹² The Proposed Decision fails to note, however, that the overearning referred to in that decision was mainly due to being allowed to collect deferred balancing account balances. It is improper for the Proposed Decision to use data from a separate proceeding, data that is not even part of the record in this proceeding, to support its analysis.

Fifth, the Proposed Decision incorrectly states that California American Water claimed in the RWE merger proceeding that the merger would provide customers “benefit from the savings on cost of capital, specifically from increased leverage.”¹³ This is incorrect. In the RWE proceeding, California American Water made no mention of benefits from increased leverage. In that proceeding, California American Water committed to not changing its capital structure as a result of the proposed transaction.¹⁴ In fact, California American Water limited its discussion of cost of capital benefits to savings related to cost of debt. Benefits from lower cost of debt and benefits from increased leverage are two different things, and the RWE decision addresses only the former.¹⁵

The Proposed Decision leaves California American Water with little choice but to adjust its capital structure to reduce its amount of debt. This result is counterintuitive because it will increase the percentage of equity, which raises the cost of capital and therefore will deprive

¹² Proposed Decision, p. 18.

¹³ Proposed Decision, p. 21.

¹⁴ See D.02-12-068, *Joint Application of California-American Water Company (U-210-W), et al.*, 2002 Cal. PUC LEXIS 909 (“D.02-12-068, 2002 Cal. PUC LEXIS 909”), *89. See also, D.07-05-031, *In the Matter of the Application of California- American Water Company (U-210-W), a California Corporation, RWE Aktiengesellschaft, a Corporation Organized Under the Laws of the Federal Republic of Germany, Thames Water Aqua Holdings GmbH, a Corporation Organized Under the Laws of the Federal Republic of Germany, and American Water Works Company, Inc. for an Order Authorizing the Sale by Thames GmbH of up to 100% of the Common Stock of American Water Works Company, Resulting in a Change of Control of California-American Water Company and For Such Related Relief as May be Necessary to Effectuate Such Transaction*, 256 P.U.R.4th 269, 2007 Cal. PUC LEXIS 140 (“D.07-05-031, 2007 Cal. PUC LEXIS 140”), *14.

¹⁵ D.02-12-068, 2002 Cal. PUC LEXIS 909, *89; D.07-05-031, 2007 Cal. PUC LEXIS 140, *26, fn 18.

customers of the benefits of a more leveraged capital structure.¹⁶ The Commission should avoid this problem by modifying the Proposed Decision as set forth in Exhibit A.

III. THE PROPOSED DECISION'S FINDINGS ON CALIFORNIA AMERICAN WATER'S ISRS PROGRAM

California American Water applauds the Commission's commitment to provide incentives for water utilities to more efficiently fund infrastructure investment. In particular, California American Water agrees with the Proposed Decision's finding that development of a long-term infrastructure replacement plan will further the Commission's important policy in the Water Action Plan of promoting water infrastructure replacement in California and that such replacement is "essential to ensuring reliable, high quality service and water."¹⁷

California American Water maintains that the implementation of the ISRS program will provide tangible benefits to customers. However, it does not object to the Proposed Decision's finding that consideration of the ISRS program should be deferred until the next general rate case. This outcome will appropriately allow California American Water to focus on the next phase of this proceeding designed to consider and implement conservation measures. California American Water expects to submit a proposal to implement ISRS for its Village and Coronado Districts in its next general rate case.

IV. CONCLUSION

For all of the foregoing reasons, California American Water respectfully urges the Commission to modify the Proposed Decision's findings on the ROE as discussed and to adopt the revised findings of fact and conclusion of law in Exhibit A.

¹⁶ See Opening Brief, p. 9 (explaining that the forecasted cost of debt for California American Water is less than the DRI forecast cost of debt for A-rated utilities).

¹⁷ Proposed Decision, p. 32, Finding of Fact 13. See also *id.* p. 27 (finding that a infrastructure system replacement program is "inherently beneficial to both ratepayers and water utilities.").

Dated: March 3, 2008

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PROOF OF SERVICE

I, Sarah E. Leeper, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years and not a party to this action. My business address is MANATT, PHELPS & PHILLIPS, LLP, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On March 3, 2008, I served the within:

***COMMENTS OF CALIFORNIA-AMERICAN WATER COMPANY ON THE PROPOSED
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on the interested parties in this action addressed as follows:

See attached service list

- ☒ **(BY MAIL)** By placing such document(s) in a sealed envelope, with postage thereon fully prepaid for first class mail, for collection and mailing at Manatt, Phelps & Phillips, LLP, San Francisco, California following ordinary business practice. I am readily familiar with the practice at Manatt, Phelps & Phillips, LLP for collection and processing of correspondence for mailing with the United States Postal Service, said practice being that in the ordinary course of business, correspondence is deposited in the United States Postal Service the same day as it is placed for collection.
- ☒ **(BY PUC E-MAIL SERVICE)** By transmitting such document electronically from Manatt, Phelps & Phillips, LLP, San Francisco, California, to the electronic mail addresses listed above. I am readily familiar with the practice of Manatt, Phelps & Phillips, LLP, for transmitting documents by electronic mail, said practice being that in the ordinary course of business, such electronic mail is transmitted immediately after such document has been tendered for filing. Said practice also complies with Rule 2.3(b) of the Public Utilities Commission of the State of California and all protocols described therein.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on March 3, 2008, at San Francisco, California.


Sarah Leeper

SERVICE LIST
A.07-01-036, A.07-01-037, A.07-01-038, A.07-01-039
Updated 3/3/08

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EXHIBIT A

Exhibit A

Revised Finding of Fact No. 11 (pp. 31-32)

A Return on Equity of 11.5 ~~10.15~~% is reasonable based on the record and is commensurate with return on investments in comparable companies and sufficient to (a) assure confidence in the financial integrity of Cal Am , (b) maintain its credit and (c) attract necessary capital investment.

Revised Finding of Fact No. 12 (p. 32)

A leverage adjustment to the ROE for increased financial risk is ~~not~~ warranted.

Revised Conclusion of Law No. 3 (p. 33)

An ROE of 11.5 ~~10.15~~% is reasonable in light of the whole record, consistent with the law, in the public interest and should be adopted.